

Message Text

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ALL AMCONSULS CANADA

C O N F I D E N T I A L SECTION 1 OF 2 OTTAWA 0531

STATE FOR COOPER AND HARTMAN; TREASURY FOR SOLOMON AND
BERGSTEN; CEA FOR SCHULTZE

E.O. 11652: GDS
TAGS: EGEN, CA
SUBJ: CANADIAN ECONOMIC REVIEW AND PROSPECTS

1. SUMMARY. 1976 WAS MEDIOCORE YEAR ECONOMICALLY FOR
CANADA WITH SOME DISTINCT PLUSES. LARGE DROP IN INFLATION
RATES, REAL GROWTH OF CLOSE TO 5 PERCENT, AND GREAT
IMPROVEMENT IN MERCHANDISE TRADE BALANCE WERE MOST
OBVIOUS EXAMPLES OF BETTER 1976 ECONOMIC PERFORMANCE THAN
1975. HOWEVER, ECONOMIC UNCERTAINTIES PREVALENT AT YEAR'S
END CAUSE FORECASTERS TO PREDICT SLOWER 1977 GROWTH,
HIGHER UNEMPLOYMENT AND CONTINUED WEAKNESS IN ECONOMY,
UNLESS GOC RELAXES CONTROLS AND/OR TAKES FISCAL
STIMULATIVE MEASURES. GOC RESTRAINT PROGRAM HAD SOME
SUCCESS IN CURBING WAGE AND PRICE SPIRAL OF PREVIOUS TWO
YEARS, BUT PROFIT CURTAILMENT IMPACTED ADVERSELY ON
CAPITAL SPENDING, THUS CONTRIBUTING TO RISE IN UNEMPLOYMENT.
ALTHOUGH CANADA IS RUNNING LARGE CURRENT ACCOUNT DEFICIT,
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DEFICIT IN 1976 WAS LESS THAN PREVIOUS YEAR AND IS
EXPECTED TO SHOW FURTHER REDUCTIONS OVER THE NEXT TWO
YEARS, AND TRADE BALANCE WAS IN SURPLUS LAST YEAR AND SHOULD
SHOW CONTINUED IMPROVEMENT. SOME FURTHER PROGRESS
IS EXPECTED IN REDUCING INFLATION RATES. STRONG
CASE CAN NOW BE MADE FOR EASING OF RESTRAINT
PROGRAM AND NEW GOC FISCAL INITIATIVES. END SUMMARY.

2. ALTHOUGH CERTAIN STATISTICAL INFORMATION ON CANADA'S ECONOMY FOR ALL OF 1976 IS NOT YET AVAILABLE, THERE ARE ENOUGH THIRD QUARTER AND SOME FOURTH QUARTER FIGURES AVAILABLE TO INDICATE CANADA'S ECONOMY IN MOST OF 1976 RECOVERED FROM STAGFLATION OF 1975. ECONOMIC GROWTH FOR ALL OF 1976 WAS BETTER THAN PREVIOUS YEAR, (ESTIMATED GNP REAL GROWTH OF ALMOST 5 PERCENT VERSUS LESS THAN 1 PERCENT IN 1975) BUT GROWTH SLOWED IN THIRD QUARTER AND SOME INDICATORS TURNED DOWNWARD.

3. ON PLUS SIDE, CANADA'S MERCHANDISE TRADE BALANCE RETURNED TO SURPLUS (OVER \$1 BILLION FOR YEAR); RATE OF INFLATION SLOWED APPRECIABLY (DECEMBER TO DECEMBER RISE IN CPI WAS ONLY 5.8 PERCENT); HOUSING STARTS INCREASED DRAMATICALLY AND SHOULD SURPASS GOC TARGET OF 250,000 FOR 1976; FIRST YEAR WAGE SETTLEMENTS DROPPED FROM 14 PERCENT IN THE FIRST QUARTER TO LESS THAN 10 PERCENT BY FOURTH QUARTER; CONSUMER CONFIDENCE WAS HIGH DURING MOST OF YEAR WITH PERSONAL EXPENDITURES ON GOODS AND SERVICES INCREASING 1.1 PERCENT IN REAL TERMS IN THIRD QUARTER; BUSINESS LOAN DEMANDS CONTINUED STRONG (UP 20 PERCENT, OCTOBER TO OCTOBER); AND CANADA'S GOOD CREDIT WORTHINESS PERMITTED RECORD BORROWINGS OVERSEAS, WITH TOTAL NET CAPITAL INFLOW IN LONG-TERM FORM REACHING C\$6.4 BILLION DURING FIRST THREE QUARTERS OF 1976, 50 PERCENT ABOVE THE ENTIRE 1975 YEAR.

4. ON NEGATIVE SIDE, UNEMPLOYMENT REMAINED AT ABOUT 7
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PERCENT LEVEL FOR MOST OF YEAR AND CREPT UP TO 7.5 PERCENT LEVEL IN DECEMBER. FIXED CAPITAL INVESTMENT IN REAL TERMS DROPPED 4.3 PERCENT IN THIRD QUARTER, AND CORPORATION PROFITS BEFORE TAXES WERE DOWN ONE PERCENT IN SAME PERIOD. BY NOVEMBER INDUSTRIAL PRODUCTION INDEX HAD DECLINED TO MARCH LEVEL, AND REAL DOMESTIC PRODUCT INDEX IN NOVEMBER WAS ABOUT SAME AS IN AUGUST. CURRENT ACCOUNT DEFICIT IN THIRD QUARTER WAS RUNNING AT ABOUT C\$4.5 BILLION ON ANNUAL BASIS, LARGELY BECAUSE OF INCREASED INTEREST PAYMENTS ON OVERSEAS DEBT AND RISE IN TRAVEL DEFICIT. ON CAPITAL ACCOUNT, CANADA RAN LARGE SURPLUSES FOR FIRST TWO QUARTERS, BUT OUTFLOW OF SHORT-TERM FUNDS RESULTED IN SURPLUS OF ONLY C\$99 MILLION IN THIRD QUARTER. NET OUTFLOW OF ALMOST C\$600 MILLION IN DIRECT INVESTMENT FLOWS FOR FIRST THREE QUARTERS WAS NOTICEABLE CHANGE FROM PREVIOUS YEARS, AND LOCAL NEWSPAPERS WERE FILLED WITH STORIES OF CANADIAN BUSINESSMEN LOOKING TO U.S. FOR EXPANSION OF THEIR OPERATIONS. RECORD BORROWING ABROAD BY CANADIAN GOVERNMENTS AND CORPORATIONS, INDUCED

PARTLY BY BANK OF CANADA'S RELATIVELY TIGHT MONEY POLICY
WITH RESULTANT LARGE SPREAD BETWEEN U.S. AND CANADIAN
INTEREST RATES (300 TO 400 BASIS POINT AT TIMES),
PRODUCED "OVER-VALUED" CANADIAN DOLLAR FOR MOST OF YEAR.
PREMIUM ON CANADIAN DOLLAR HURT TOURIST BUSINESS, WITH
U.S. TOURISTS DOWN OVER 6 PERCENT, AND PROBABLY HINDERED
SOME EXPORT BUSINESS.

5. WHEN ECONOMIC ACTIVITY BEGAN TO SLOW IN OTHER
INDUSTRIAL COUNTRIES ABOUT MID-YEAR AND GOC PLANNERS
HERE FORCED TO REVISE DOWNWARD THEIR PROJECTIONS FOR
CANADIAN ECONOMY, FINMIN MACDONALD CAME UNDER PRESSURE
TO ADOPT STIMULATIVE MEASURES. HOWEVER, HE HELD LARGELY
TO GOC GAME PLAN OF FIGHTING INFLATION AND ONLY HINTED
IN NOVEMBER THAT HIS SPRING 1977 BUDGET MIGHT CONTAIN
SOME TAX RELIEF OR BUSINESS STIMULI. BUDGET DEFICIT
REMAINED AT ABOUT 2 PERCENT OF GDP, WITH SOME REAL
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GROWTH IN EXPENDITURES. HOWEVER, BANK OF CANADA LOWERED
BANK RATE TWICE IN LATE 1976 IN REACTION TO LOWER
MARKET INTEREST RATES AND DECREASE IN GROWTH OF MONEY
SUPPLY.

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6. IN LATE DECEMBER, CONFERENCE BOARD IN CANADA RELEASED ITS FORECASTS FOR ECONOMY IN 1977 AND CONCLUDED THAT WITHOUT CHANGE IN GOC POLICIES REAL ECONOMIC GROWTH (ABOUT 3 PERCENT) WOULD BE LESS THAN IN 1976 AND EMPLOYMENT WOULD BE HIGHER (7.9 PERCENT). PESSIMISTIC VIEW OF CAPITAL SPENDING INTENTIONS, STAGNANT CORPORATE PROFITS, WEAK BUSINESS CONFIDENCE (POLLED AT 2-YEAR LOW), DECLINING HOUSING ACTIVITY AND UNCERTAINTIES FOLLOWING SEPARATIST VICTORY IN QUEBEC ALL CONTRIBUTED TO LOWERED EXPECTATIONS. ABOUT ONLY CURRENT BRIGHT SPOT IN ECONOMY WAS CONSUMER SPENDING, WITH DEPARTMENT STORE SALES OVER 12 PERCENT HIGHER IN DECEMBER THAN YEAR PREVIOUS. IN EARLY JANUARY, MINISTRY OF INDUSTRY, TRADE AND COMMERCE GAVE FAIRLY GLOOMY OUTLOOK FOR 1977 WITH MUCH SAME REASONS AS CONFERENCE BOARD, AND MCDONALD DOESN'T DISPUTE IT. CHARTERED BANKS AND BROKERAGE HOUSES HAVE SINCE REVISED DOWNWARD THEIR FORECASTS FOR REAL GROWTH IN ECONOMY IN 1977 TO ABOUT 4 PERCENT AND ARE PREDICTING RISE IN UNEMPLOYMENT CLOSE TO 8 PERCENT LEVEL.

7. ALL AGREE OF COURSE THAT U.S. STIMULUS PACKAGE WILL
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HELP ESPECIALLY IN SECOND HALF, BUT FORECASTS GIVEN
ABOVE ALREADY ALLOW FOR IT.

8. MONETARY POLICY HAS EASED OVER PAST THREE MONTHS, WITH BANK OF CANADA DROPPING BANK RATE THREE TIMES DURING THAT PERIOD AND ALSO LOWERING SECONDARY RESERVE REQUIREMENTS IN FEBRUARY. LOWER CANADIAN INTEREST RATES AND BOTTOMING OUT OF U.S. RATES HAVE REDUCED INTEREST RATE DIFFERENTIALS. THIS SHOULD ENCOURAGE BORROWING IN DOMESTIC CAPITAL MARKETS, REDUCING THE RECORD HIGH RATES OF FOREIGN BORROWING AND CAPITAL INFLOWS WHICH PREVAILED IN 1976. (SEE SEPTTEL FOR DETAILS ON CANADA'S FOREIGN DEBT AND BALANCE OF PAYMENTS OUTLOOK.)

9. ALTHOUGH MACDONALD TOLD PROVINCIAL FINANCE MINISTERS FEBRUARY 1 THAT "THERE IS AN OBVIOUS CASE FOR MEASURES OF ECONOMIC STIMULUS" BECAUSE OF OUTLOOK FOR WEAK GROWTH IN PRODUCTION AND EMPLOYMENT, HE INDICATED THAT CURRENT THRUST OF GOC FISCAL POLICY WAS STILL RESTRAINT. HE LEAVES IMPRESSION IN HIS PUBLIC STATEMENTS AND PRIVATELY THAT HIS SPRING BUDGET (NOW SCHEDULED FOR MARCH OF EARLY APRIL) WILL PROBABLY STIMULATE PRIVATE INVESTMENT SPENDING, BUT HE RETURNS CONSISTENTLY TO ANTI-INFLATION THEMES.

10. OFFICIALS HERE DO NOT SEEM OVERLY CONCERNED ABOUT

CURRENT TRENDS. THEY FEEL BASIC STRENGTHS OF CANADIAN ECONOMY WILL BE REASSERTED WHEN OTHER INDUSTRIAL COUNTRIES, PARTICULARLY U.S., RESTIMULATE THEIR ECONOMIES. MACDONALD ALSO SUBSCRIBES TO THIS LINE OF THINKING, WHICH PLACES EMPHASIS ON CURBING EXPECTATIONS OF INFLATIONARY GROWTH, SOME "FINE-TUNING" OF ECONOMY IN 1977, AND FAVORABLE REACTION IN CANADA TO STIMULATIVE EFFORTS IN U.S.

11. HOWEVER, THERE HAS BEEN SLIPPAGE IN SYNCHRONIZATION
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OF U.S. AND CANADIAN ECONOMIES OVER PAST FEW YEARS, AND CANADIAN ECONOMY MAY NOT REACT SO QUICKLY AND STRONGLY TO U.S. DEVELOPMENTS AS IN PAST. WHILE SOME ELEMENTS IN TWO ECONOMIES (E.G., INFLATION AND WAGE RATES) MAY FOLLOW SOME GENERAL TREND LINES, PEAKS AND TROUGHS DIVERGE MORE, AND SOME SECTORS GO OPPOSITE WAYS. THUS, CANADA ONLY EXPERIENCED MILD RECESSIONS IN 1974 AND EARLY 1975, AS OPPOSED TO DISTINCT DROP IN U.S. REAL GNP GROWTH. ON OTHER HAND, U.S. INDUSTRIAL OUTPUT WAS CLIMBING AT END OF 1976 AND CANADA'S WAS HOLDING STEADY. ALSO, WITH WAGE AND PRICE CONTROLS, GOC HAS MADE MASSIVE AND PROLONGED INTRUSION INTO PRIVATE ECONOMIC SECTOR, RESULTS OF WHICH MAY HAVE ADVERSE EFFECTS ON BUSINESS CLIMATE HERE FOR YEARS TO COME. IN SOME BUSINESS SECTORS, (E.G., PULP AND PAPER AND MANY MANUFACTURED ITEMS), U.S. IS MORE COMPETITIVE BECAUSE OF LOWER WAGE RATES AND HIGHER PRODUCTIVITY, AND WITH EXCESS CAPACITY IN U.S., DEMAND FOR CERTAIN CANADIAN PRODUCTS MAY NOT AUTOMATICALLY FOLLOW PICKUP IN U.S. ECONOMIC ACTIVITY.

12. CONCLUSION: A GOOD CASE EXISTS FOR GREATER STIMULUS IN THE SPRING BUDGET THAN MACDONALD SEEMS TO FAVOR. SLOW GROWTH BELOW FOUR PERCENT, HIGH AND RISING UNEMPLOYMENT, REDUCED TOTAL GOVERNMENT DEFICITS UNDER CURRENT POLICIES, POOR OUTLOOK FOR INVESTMENT AND LACK OF BUSINESS CONFIDENCE AS SHOWN IN RECENT SURVEYS, ALMOST NO CHANGE IN THE LEVEL OF REAL PRIVATE INVESTMENT OVER THE PAST YEAR IN THE NON-ENERGY SECTOR, AND UNDERUTILIZED CAPACITY ALL CALL FOR FURTHER STIMULUS TO COMPLEMENT CURRENT MONETARY EASE.

13. WITH LARGE SWING IN MERCHANDISE TRADE BALANCE -- FROM DEFICIT OF ABOUT C\$1 BILLION IN 1975 TO SURPLUS OF OVER C\$1 BILLION IN 1976 -- CURRENT ACCOUNT DEFICIT FOR 1976 WILL BE LESS THAN C\$4.9 BILLION OF PREVIOUS YEAR. ON BASIS OF CURRENT FORECASTS FOR U.S.
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REAL GNP GROWTH OF NEARLY 5 PERCENT IN 1977 AND
LAGGING CANADIAN ECONOMIC PERFORMANCE, CANADA'S CURRENT
ACCOUNT DEFICIT IS EXPECTED TO CONTINUE TO SHRINK FOR
NEXT YEAR OR TWO. CANADA'S PAYMENTS OUTLOOK WOULD THUS
NOT APPEAR TO PRECLUDE SOME FURTHER FISCAL STIMULUS
IN SPRING BUDGET.

14. FINALLY, GIVEN CURRENT UNDER-UTILIZATION OF RESOURCES,
INFLATIONARY EXPECTATIONS ARE MORE APT TO BE AFFECTED
BY THE NATURE AND TIMING OF DECONTROLS OVER WAGES AND
PROFITS THAN BY FURTHER FISCAL STIMULUS.
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